

MERCHANTS GROUP INC

Form 10-Q

November 14, 2005

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
Form 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

**For the quarterly period ended September 30, 2005**

**or**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_.**

**Commission File Number 1-9640**

**MERCHANTS GROUP, INC.**

*(Exact name of registrant as specified in its charter)*

**Delaware**

*(State or other jurisdiction of incorporation or organization)*

16-1280763

*(I.R.S. Employer Identification No.)*

**250 Main Street, Buffalo, New York**

*(Address of principal executive offices)*

**14202**

*(Zip Code)*

**716-849-3333**

*(Registrant's telephone number, including area code)*

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months, and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by checkmark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act).

Yes  No

Indicate by checkmark whether the registrant is a shell company (as defined in Rule 12b-2 under the Exchange Act).

Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date (November 10, 2005): **2,114,152 shares of Common Stock.**

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## PART I. FINANCIAL INFORMATION

**Item 1. Financial Statements**

MERCHANTS GROUP, INC.  
 CONSOLIDATED BALANCE SHEET  
 (in thousands)

	September 30, 2005 (unaudited)	December 31, 2004
Assets		
Investments:		
Fixed maturities:		
Available for sale at fair value (amortized cost \$179,318 in 2005 and \$184,171 in 2004)	\$ 177,048	\$ 184,092
Preferred stock at fair value	4,463	3,509
Other long-term investments at fair value	669	2,696
Short-term investments	3,413	7,412
Total investments	185,593	197,709
Cash	30	145
Interest due and accrued	1,103	1,079
Premiums receivable from affiliate, net of allowance for doubtful accounts of \$180 in 2005 and \$215 in 2004	14,042	15,136
Deferred policy acquisition costs from affiliate	6,667	7,570
Reinsurance recoverable on paid and unpaid losses	15,914	15,630
Prepaid reinsurance premiums from affiliate	4,932	4,595
Deferred income taxes	5,315	5,028
Receivable from affiliate	661	
Other assets	12,017	13,557
Total assets	\$ 246,274	\$ 260,449

See Notes to the Consolidated Financial Statements

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MERCHANTS GROUP, INC.  
CONSOLIDATED BALANCE SHEET  
(in thousands except share amounts)

	September 30, 2005 (unaudited)	December 31, 2004
Liabilities and Stockholders' Equity		
Liabilities:		
Reserve for losses and loss adjustment expenses (affiliate \$48,874 and \$43,724)	\$ 119,880	\$ 128,415
Unearned premiums from affiliate	30,574	33,685
Payable for securities	2,920	4,751
Payable to affiliate		5,571
Retrospective commission payable to affiliate	1,231	1,141
Income taxes payable	797	
Other liabilities (affiliate \$4,402 and \$4,262)	14,826	14,912
Total liabilities	170,228	188,475
Stockholders' equity:		
Common stock, 10,000,000 shares authorized, 2,114,152 shares issued and outstanding at September 30, 2005 and December 31, 2004	33	33
Additional paid in capital	35,878	35,878
Treasury stock, 1,139,700 shares at September 30, 2005 and December 31, 2004	(22,766)	(22,766)
Accumulated other comprehensive loss	(1,917)	(536)
Accumulated earnings	64,818	59,365
Total stockholders' equity	76,046	71,974
Commitments and contingent liabilities		
Total liabilities and stockholders' equity	\$ 246,274	\$ 260,449

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MERCHANTS GROUP, INC.  
 CONSOLIDATED STATEMENT OF OPERATIONS  
 (in thousands except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
	(unaudited)			
Revenues:				
Net premiums earned from affiliate	\$ 12,155	\$ 14,161	\$ 36,899	\$ 42,594
Net investment income	1,890	1,935	5,734	5,954
Net investment gains				470
Other revenues from affiliate	163	185	413	448
<b>Total revenues</b>	<b>14,208</b>	<b>16,281</b>	<b>43,046</b>	<b>49,466</b>
Expenses:				
Net losses and loss adjustment expenses (\$8,362, \$8,011, \$20,205 and \$24,708 from affiliate)	7,074	8,941	18,985	28,182
Amortization of deferred policy acquisition costs from affiliate	3,160	3,677	9,594	11,074
Other underwriting expenses (\$1,275, \$2,264, \$5,177 and \$5,196 from affiliate)	1,490	2,354	5,852	5,813
<b>Total expenses</b>	<b>11,724</b>	<b>14,972</b>	<b>34,431</b>	<b>45,069</b>
Income before income taxes	2,484	1,309	8,615	4,397
Income tax provision	763	146	2,528	873
Net income	\$ 1,721	\$ 1,163	\$ 6,087	\$ 3,524
Earnings per share:				
Basic	\$ .81	\$ .55	\$ 2.88	\$ 1.67
Diluted	\$ .81	\$ .55	\$ 2.87	\$ 1.66
Weighted average shares outstanding:				
Basic	2,114	2,114	2,114	2,113
Diluted	2,120	2,119	2,119	2,118

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MERCHANTS GROUP, INC.  
CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME (LOSS)  
(in thousands)

	Three Months		Nine Months	
	Ended September 30,		Ended September 30,	
	2005	2004	2005	2004
	(unaudited)			
Net income	\$ 1,721	\$ 1,163	\$ 6,087	\$ 3,524
Other comprehensive income (loss) before taxes:				
Unrealized gains (losses) on securities	(1,797)	2,812	(2,092)	(1,257)
Reclassification adjustment for gains included in net income				(470)
Other comprehensive income (loss) before taxes	(1,797)	2,812	(2,092)	(1,727)
Income taxes (benefit) related to items of other comprehensive income (loss)	(611)	956	(711)	(587)
Other comprehensive income (loss)	(1,186)	1,856	(1,381)	(1,140)
Comprehensive income (loss)	\$ 535	\$ 3,019	\$ 4,706	\$ 2,384

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MERCHANTS GROUP, INC.  
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY  
(in thousands)

	Nine Months Ended September 30, 2005                      2004 (unaudited)	
Common stock:		
Beginning of period	\$     33	\$     32
Exercise of common stock options		1
End of period	33	33
Additional paid in capital:		
Beginning of period	35,878	35,795
Exercise of common stock options		83
End of period	35,878	35,878
Treasury stock beginning and end:	(22,766)	(22,766)
Accumulated other comprehensive loss:		
Beginning of period	(536)	750
Other comprehensive loss	(1,381)	(1,140)
End of period	(1,917)	(390)
Accumulated earnings:		
Beginning of period	59,365	56,448
Net income	6,087	3,524
Cash dividends (to affiliate \$77 and \$77)	(634)	(633)
End of period	64,818	59,339
Total stockholders equity	\$ 76,046	\$ 72,094

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MERCHANTS GROUP, INC.  
CONSOLIDATED STATEMENT OF CASH FLOWS  
(in thousands)

	Nine Months Ended September 30,	
	2005	2004
	(unaudited)	
Cash flows from operations:		
Collection of premiums from affiliate	\$ 35,139	\$ 40,843
Payment of losses and loss adjustment expenses (affiliate (\$15,056) and (\$16,760))	(26,525)	(36,628)
Payment of other underwriting expenses (affiliate \$(13,970) and \$(15,680))	(14,870)	(16,200)
Investment income received	5,908	6,258
Investment expenses paid	(308)	(211)
Income taxes paid	(1,308)	(376)
Other from affiliate	412	447
Net cash used in operations	(1,552)	(5,867)
Cash flows from investing activities:		
Proceeds from fixed maturities sold or matured	43,818	35,470
Purchase of fixed maturities	(38,860)	(22,567)
Net (increase) decrease in preferred stock	(850)	2,000
Net (increase) decrease in other long-term investments	2,027	(982)
Net (increase) decrease in short-term investments	3,999	(9,768)
Increase (decrease) in payable for securities	(1,831)	3,867
Decrease in receivable for securities		893
Net cash provided by investing activities	8,303	8,913
Cash flows from financing activities:		
Settlement of affiliate balances, net	(6,232)	(2,515)
Exercise of common stock options		84
Cash dividends (to affiliate \$77 and \$77)	(634)	(633)
Net cash used in financing activities	(6,866)	(3,064)
Decrease in cash	(115)	(18)
Cash:		
Beginning of period	145	23
End of period	\$ 30	\$ 5

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MERCHANTS GROUP, INC.  
CONSOLIDATED STATEMENT OF CASH FLOWS  
RECONCILIATION OF NET INCOME TO NET CASH  
USED IN OPERATIONS  
(in thousands)

	Nine Months Ended September 30,	
	2005	2004
	(unaudited)	
Net income	\$ 6,087	\$ 3,524
Adjustments:		
Accretion	(110)	(53)
Realized investment gains		(470)
(Increase) decrease in assets:		
Interest due and accrued	(24)	146
Premiums receivable from affiliate	1,094	1,377
Deferred policy acquisition costs from affiliate	903	849
Reinsurance recoverable on paid and unpaid losses	(284)	1,936
Prepaid reinsurance premiums from affiliate	(337)	(1,757)
Income taxes receivable		881
Deferred income taxes	424	(266)
Other assets	1,540	(115)
Increase (decrease) in liabilities:		
Reserve for losses and loss adjustment expenses (affiliate \$(5,150) and \$7,948)	(8,535)	(10,157)
Unearned premiums from affiliate	(3,111)	(1,476)
Income taxes payable	797	110
Retrospective commission payable to affiliate	90	
Other liabilities (affiliate \$139 and \$(493))	(86)	(396)
Net cash used in operations	\$ (1,552)	\$ (5,867)

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MERCHANTS GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**1. Principles of Consolidation and Basis of Presentation**

The consolidated balance sheet as of September 30, 2005 and the related consolidated statements of operations and comprehensive income for the three and nine month periods ended September 30, 2005 and 2004, and changes in stockholders' equity and cash flows for the nine months ended September 30, 2005 and 2004, respectively, the (Financial Statements) are unaudited. In the opinion of management, the interim financial statements reflect all adjustments necessary for a fair presentation of financial position and results of operations. Such adjustments consist only of normal recurring items. Interim results are not necessarily indicative of results for a full year.

The consolidated financial statements include the accounts of Merchants Group, Inc. (the Company), its wholly-owned subsidiary, Merchants Insurance Company of New Hampshire, Inc. (MNH), and M.F.C. of New York, Inc., an inactive premium finance company which is a wholly-owned subsidiary of MNH. The accompanying consolidated financial statements should be read in conjunction with the following notes and the Notes to Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2004.

The consolidated financial statements have been prepared in conformity with generally accepted accounting principles (GAAP) which differ in some respects from those followed in reports to insurance regulatory authorities. All significant intercompany balances and transactions have been eliminated.

**2. Related Party Transactions**

The Company and MNH operate and manage their business in conjunction with Merchants Mutual Insurance Company (Mutual) under a services agreement (the Services Agreement) which became effective on January 1, 2003. At September 30, 2005 Mutual owned 12.1% of the Company's issued and outstanding common stock. The Company and MNH do not have any operating assets or employees. Under the Services Agreement, Mutual provides the Company and MNH with the facilities, management and personnel required to operate their day-to-day business. The Services Agreement covers substantially the same services previously provided under a management agreement among the Company, MNH and Mutual from 1986 to 2002. The Services Agreement provides for negotiated fees (subject to periodic adjustment) for administrative, underwriting, claims and investment management services. As of January 1, 2003 MNH and Mutual entered into a reinsurance pooling agreement (the Reinsurance Pooling Agreement) that provides for the pooling, or sharing, of the insurance business traditionally written by Mutual and MNH. The Reinsurance Pooling Agreement applies to premiums earned and losses incurred on or after its effective date.

The Financial Statements include supplemental disclosure of affiliate balances, which represent the effects of the Services Agreement and the Reinsurance Pooling Agreement. In certain instances, particularly for

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Net losses and loss adjustment expenses, the affiliate amount may exceed the amount presented in the line item, because of changes in estimates (particularly reserves for losses and LAE) relating to years prior to the effective date of the Reinsurance Pooling Agreement.

The terms of these agreements are more fully described under the heading Administration in Part I, Item 1, Business, in the Company's Annual Report on Form 10-K for the year ended December 31, 2004. In accordance with the terms of the Services Agreement in June 2005 the Company and MNH issued notice to Mutual to terminate the Investment and Cash Management Services Annex of the Services Agreement as of June 30, 2006. The Company and MNH intend to solicit bids, including possibly from Mutual, for the management of their investment portfolios after the effective date of termination.

**3. Earnings Per Share**

Basic and diluted earnings per share were computed by dividing net income by the weighted average number of shares of common stock outstanding during each period. For diluted earnings per share, the weighted average number of shares outstanding was increased by the assumed exercise of options for each period. The effect on the number of shares outstanding assumes the proceeds to the Company from exercise were used to purchase shares of the Company's common stock at its average market value per share during the period. The number of options assumed to be exercised and the incremental effect on average shares outstanding for purposes of calculating diluted earnings per share are shown below:

	Three Months		Nine Months	
	Ended September 30,		Ended September 30,	
	2005	2004	2005	2004
Options assumed exercised	31,500	31,500	31,500	31,500
Incremental shares outstanding	5,504	4,542	5,166	4,911

**4. Reserve for Loss and Loss Adjustment Expenses**

The following table presents the liability for reserves for loss and loss adjustment expenses separated into case reserves, reserves for losses incurred but not reported (IBNR) and reserves for loss adjustment expense (LAE) by major product:

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	September 30, 2005	December 31, 2004
Case reserves:		
Private passenger automobile liability	\$ 7,368	\$ 10,099
Homeowners	2,083	2,098
Commercial auto liability	6,087	7,677
Workers compensation	14,480	15,697
Commercial package	13,524	13,795
General liability	717	750
Other	286	243
Total case reserves	44,545	50,359
IBNR:		
Private passenger automobile liability	4,871	6,197
Homeowners	318	257
Commercial auto liability	5,847	6,154
Workers compensation	7,973	9,884
Commercial package	16,531	14,467
General liability	1,976	1,107
Other	(288)	(223)
Total IBNR	37,228	37,843
Reserve for LAE:		
Private passenger automobile liability	2,097	2,973
Homeowners	552	640
Commercial auto liability	1,645	1,852
Workers compensation	2,067	2,125
Commercial package	12,376	13,712
General liability	3,315	3,145
Other	141	136
Total reserve for LAE	22,193	24,583
Reinsurance recoverables	15,914	15,630
Reserve for losses and LAE	\$ 119,880	\$ 128,415

Included in the reserve for losses and LAE at September 30, 2005 was \$12,213,000 of reserves for accident years 1995 and prior. Reserves related to workers compensation comprised \$8,571,000 of this amount at September 30, 2005. The following table presents workers compensation claim count and paid loss data for accident years older than ten years as of each date:

For the	For the year ended
------------	-----------------------

nine  
months  
September  
30,                      December 31,  
2005                      2004  
(dollars in thousands)

Number of claims